The Mechanics of California's Manufacturers' Investment Credit (MIC)

by Chris Micheli, Gina Rodriquez, E. Scott Ewing, and Virginia Gates

INDEX

I. Background on the Partial Exemption
II. Background on the MIC
III. Qualified Taxpayer
IV. Qualified Property
V. Qualified Costs
VI. Claiming the MIC
VII. Limitations on the MIC
VIII. The MIC and Leases
IX. Pass-Through Entities
X. MIC Regulations
XI. MIC Audit Problems

California offers several significant tax incentives for businesses engaged in manufacturing in the state. In recent years, the Legislature and Governor have made those incentives even more attractive for taxpayers. The most important and broad-based of these incentives is the manufacturers' investment credit ("MIC"), which was patterned after the federal investment tax credit (ITC).

In 1993, California enacted a 6% investment tax credit (hereinafter referred to as the "MIC") and a partial sales/use tax exemption (equal to the 5% state share) (hereinafter referred to as the "partial exemption") for the purchase of certain property used by manufacturers (California Revenue & Taxation Code [CRTC] §§ 17053.49 and 23649 [MIC] and 6377 [partial exemption]).

Background on the Partial Exemption

A partial exemption from the sales or use tax is also available to certain taxpayers who would otherwise be subject to tax on an item of machinery or equipment. Generally, the same property that qualifies for the MIC will qualify for the partial exemption.

For purchases made after January 1, 1994, but prior to December 31, 1994, the exemption equals six percent (6%). For purchases made after December 31, 1994, the exemption equals five percent (5%).

Note that the partial exemption is only available to a "new trade or business" (formed or organized after December 31, 1993, or that commenced doing business in California after that date). A "new trade or business" is defined as one that commences manufacturing under Division D of the SIC Manual within the past three years. The partial exemption is only available for the first three years of a business' operation (but six years for certain leases).

Background on the MIC

California's MIC may be used to reduce a taxpayer's income or franchise tax. The MIC was enacted in 1993 by the California Legislature (Sb 671, Alquist, Ch. 881), but it was not effective until taxable or income years beginning on or after January 1, 1994. In an unusual move, the California Legislature delayed the credit by requiring that first and second year costs and resulting credits be claimed on the 1995 returns.

The MIC began life as a proposed sales/use tax exemption for manufacturing equipment but, in a compromise, it was adopted as the MIC, a tax credit. Thus, the MIC is viewed by many of its beneficiaries as the equivalent of a credit against their sales/use tax payment.

The MIC continues to be the subject of proposed legislation, with efforts almost every year to extend the MIC to new industries or to broaden the definitions under the law. It has been expanded on only a few occasions for specialized manufacturing activities.

The credit is scheduled to sunset on January 1, 2001, but only if 100,000 new manufacturing sector jobs are not created in California during the period from January 1, 1994 to January 1, 2001. It is likely that the credit will not sunset because the current job growth (over 207,000 jobs since 1994) in California in the manufacturing sector will easily outpace the goal in the sunset date provision.

Qualified Taxpayer

A qualified taxpayer may be an individual, trust, partnership, corporation, S corporation, or LLC. A qualified taxpayer must be engaged in at least one line of business that is classified as an operating establishment under Division D, Manufacturing (SIC Codes 2011 through 3999 of the Standard Industrial Classification Manual (SIC) Manual, 1987 edition, issued by the U.S. Office of Management and Budget).

For taxable or income years beginning on or after January 1, 1998, SIC Codes 7371 through 7373 (relating to developers or manufacturers of prepackaged software or custom software) are included in the definition of qualified taxpayer.

Taxpayers operating in an enterprise zone may claim the enterprise zone sales/use tax credit and the MIC for the same property. Taxpayers claiming the enterprise zone business expense deduction must reduce MIC qualified costs by the amount of the deduction before computing the MIC.

However, taxpayers that operated in the former Los Angeles Revitalization Zone (LARZ) are not eligible to claim both the LARZ sales/use tax credit and the MIC for the same property. Taxpayers claiming the LARZ business expense deduction must reduce MIC qualified costs by the amount of the deduction before computing the MIC.

Qualified Property

Generally, qualified property is new or used tangible personal property defined in IRC Section 1245(a) and used primarily (50% of more of the time) in manufacturing or other related qualified activity. Qualified activities include:

- Manufacturing, processing, refining, fabricating, or recycling;
- Research and development;
- Maintaining, repairing, testing, or measuring other qualified property;
- Pollution control (meeting or exceeding established state or local standards).

Qualified property also includes certain computers and computer peripheral equipment used in specified activities in SIC Codes 7371 through 7373 taxpayers (on or after January 1, 1998) and certain special purpose buildings and foundations used by certain taxpayers. These taxpayers include computer manufacturers, biotechnology, biopharmaceutical, and commercial space firms.

R&D property can also qualify for the MIC provided that the property is used as part of the manufacturing process and that the R&D activity supports the manufacturing process. However, cost expenses under IRC Section 174 are not qualified costs for the MIC and pure R&D companies, which are not classified under SIC manufacturing codes, are generally not qualified taxpayers for the MIC.

Qualified Costs

The MIC is six percent (6%) of all qualified costs. To qualify for the credit, costs must meet all of the following criteria:

- Paid or incurred on or after January 1, 1994, for the acquisition, construction or reconstruction of qualified property;
- Amounts upon which California sales/use tax were paid (except for capitalized labor costs); and

- Amounts that are properly chargeable to the qualified taxpayer's capital account (cost basis for depreciation), except for certain operating or "true" leases.

Qualified costs may also include capitalize labor costs paid or incurred that are directly allocable to the construction or modification of qualified property (direct costs as defined in IRC Section 263A). Unlike some other credits, there is no basis reduction for depreciation purposes when a taxpayer claims the MIC for a given item of qualified property.

Claiming the MIC

The MIC is claimed on Form FTB 3535, "Manufacturers' Investment Credit," for the year in which the qualified property is placed in service in California. Any credit earned during the 1994 taxable or income year must be claimed on the 1995 Form 3535.

Amended returns can be filed to claim the MIC, as long as the applicable statute of limitation period is open (generally four years from the date a timely return is filed or one year from the date of the overpayment, whichever period expires later).

Limitations on the MIC

There is no yearly dollar limitation on the amount of the MIC that the taxpayer may accrue during any year. Any MIC exceeding the tax liability for the current year may be carried over to future years. Generally, any part of the credit exceeding the tax liability for the current taxable or income year may be carried over for a maximum of eight years. Some "small businesses" qualify for a ten-year carryover period.

The credit is not allowed for any property for which a California sales/use tax exemption or refund has been claimed. The credit cannot reduce the minimum franchise tax or annual tax (for corporations, LLCs, LPs, LLPs, and S corporations), built-in gains tax (for S corporations), or the excess net passive income tax (for S corporations).

The MIC is not a refundable credit. Any MIC that is not used to offset the qualified taxpayer's income or franchise tax must be carried over to future years. The credit may not reduce the alternative minimum tax (AMT). However, the credit may reduce the regular tax below the tentative minimum tax (TMT).

The MIC and Leases

Leases or lease finance arrangements can qualify for the MIC, but only if the sales or use tax is paid by the lessor when the property is acquired. In this situation, the lessee may take the entire credit for the year in which the lessee placed the qualified property in service for costs upon which the lessor paid California sales or use tax if certain requirements are met.

The lessor must acquire the qualified property on or after January 1, 1993 and the lease with the qualified taxpayer must have also been commenced on or after January 1, 1994. Under an operating or "true" lease, the cost of the property does not have to be chargeable to the qualified taxpayer's capital account (but the transaction must be treated as a sale for sales and use tax purposes).

However, under a finance or capital lease, the property must be chargeable to the qualified taxpayer's capital account (i.e., it must be capitalized). The credit is computed using the lessor's original cost of the qualified property upon which California sales/use tax was paid.

Within 45 days after the close of the lessee's taxable or income year for which the MIC is allowable, the lessor is required to provide a statement to the lessee specifying that the amount of the lessor's cost upon which sales/use tax has been paid and the amont of qualified costs eligible for the credit.

However, this requirement is only to insure that the lessor provides the information in a timely manner. No penalty or disallowance of the credit should result if this information is provided at a later date, as long as the information is available so that the lessee can calculate the qualified costs for the credit. Obviously, the FTB may require this information on audit.

Pass-through Entities

The MIC is passed through to taxpayers in the same manner as other credits. In the case of S corporations, the corporation may claim one third of the credit against the 1.5% entity-level tax and then pass through 100% of the credit to the S corporation shareholders. In the case of partnerhips and LLCs (that are taxed as partnerships), the credit is earned at the entity level and passed through to partners or members.

The MIC (including any carryover amount) is allowed only to the qualified taxpayer (entity) that earns the credit. For example, a subsidiary corporation that places qualified property in service and generates a MIC may not allocate the credit to the parent corporation. Further, a corporation that is a member of a unitary group (or is otherwise affiliated) may not allocate or otherwise transfer the credit to any other members of the unitary group (or any other corporation).

MIC Regulations

The MIC regulations are contained in the California Code of Regulations, Title 18, Sections 17053.49-0 through 17053.49-11 (Personal Income Tax) and 23649-0 through 23649-11 (Bank and Corporation Tax). The FTB adopted these comprehensive regulations in 1996. They include many useful examples. However, keep in mind that the statutes always take precedent over the regulations.

MIC Audit Problems

According to taxpayers and FTB staff, field audits have begun in earnest on MIC returns. Some audits have been described by taxpayers as "aggressive." Moreover, FTB staff believe that there will be sizeable adjustments made, meaning that taxpayers will be denied credits and face larger tax bills, including interest and penalties.

Some of the most common issues arising from field audits are whether particular property is tangible personal property or whether it is being used as part of the manufacturing process. Other taxpayer questions have focused on like-kind exchanges or whether a particular activity falls within the proper SIC Code assignment.

A ripe area for controversy and likely litigation is capitalized labor, especially associated with third-party construction contract costs. Another area of dispute between the FTB and taxpayers concerns the use of tangible personal property in research and development. One additional problem for taxpayers is that FTB audit staff is using a very narrow definition of R&D.

The bottom line is this: As with all tax benefits, it is important to be careful that you comply with the letter and intent of the law and document your purchases sufficiently so that, upon audit, there will not be a large determination of taxes due, which will grow with interest and penalties.

The following have been specific areas of concern for taxpayers in MIC audits:

- *Lack of Substantiation* – Some companies have claimed the MIC, but have not kept adequate records to substantiate the credit upon audit.

- *Aggressive Audit Claims* – Some companies have not done a thorough review of their property to ensure that all property included in the MIC calculation is qualified. Some companies simply multiply the MIC percentage by all capitalized property.

- *Section 1245 Property Limitations* – It is often difficult to identify Section 1245 property in the manufacturing setting. Sometimes assets in a manufacturing environment seem to be Section 1245 property, but perhaps are really leasehold improvements that are more properly classified under Section 1250. Will the FTB accept cost segregation studies? Is it too burdensome to require taxpayers to go through such studies?

- *Documentation Burden for Self-Construction and Contractors* – The FTB is taking the position that the MIC should not be calculated on items such as overhead or the mark-up taken by contractors. They are putting the burden on the taxpayer to determine from the contractors what the overhead and profit margin is, or requiring a burdensome formula to estimate those costs. If the state is concerned about abuse or excessive MIC usage, some say it should consider a reasonable method for hair-cutting the benefit on third-party constructed assets. There are those that argue it should be similar to the R&D credit qualified research expense of 65% for contract work.

- *Credit Against Combined Income* – The FTB's long-held position is that credits are available only to offset the income of the entity within the unitary group that generated the credit is very restrictive.

- *Carryforward Period* – It is only 8 years for large businesses and 10 years for small businesses; should it be longer, such as 15 years? Or should it be an indefinite period until the credit is used, similar to the R&D and other California tax credits?

Chris Micheli *is an attorney and registered lobbyist with the Sacramento governmental relations firm of Carpenter Snodgrass & Associates. He was the lead lobbyist on the original MIC statute.* ***Gina Rodriquez*** *is an enrolled agent and Sacramento Editor for Spidell Publishing, Inc.* ***Virginia Gates*** *is a partner at PricewaterhouseCoopers in San Jose. She was a principal draftsperson of the original MIC statute.* ***E. Scott Ewing*** *is an attorney with the Deloitte & Touche Multistate Tax Group in Los Angeles. He previously served as an FTB Staff Counsel where he was the principal draftsperson of the MIC regulations.*